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No. 89-1965

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In The  
**Supreme Court of the United States**  
October Term, 1990

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COTTAGE SAVINGS ASSOCIATION,

*Petitioner.*

v.

COMMISSIONER OF INTERNAL REVENUE,  
*Respondent.*

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On Writ Of Certiorari To  
The United States Court Of Appeals  
For The Sixth Circuit

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REPLY BRIEF

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## REPLY ARGUMENT

### I. THE GOVERNMENT HAS VIRTUALLY ABANDONED ITS SECTION 165 ARGUMENT.

The Government has virtually abandoned the Sixth Circuit's conclusion that Section 165 of the Code (Petitioner's Brief at 13-26) prevents deduction of Cottage Savings Association's loss on the transaction at issue by relegating its position to a mere footnote. Respondent's Brief at 34, n. 39. Apart from its mistaken reliance on Section 165 to deny Cottage's loss, the Sixth Circuit agreed with the decisions of the Fifth Circuit in *Centennial, First Federal of Temple and San Antonio*<sup>1</sup> and the D.C. Circuit in *Federal National Mortgage Association*<sup>2</sup> that losses from the exchange of mortgage loans for completely different mortgage loans should be realized as well as recognized under the tax law. Thus, no real conflict exists among the circuit courts with respect to the issue of realization of losses which is before the Court in this case and in *Centennial* (to be argued in tandem with this case<sup>3</sup>) and the other cases for which certiorari is pending.

### II. THE MORTGAGE LOANS THAT PETITIONER EXCHANGED WERE MATERIALLY DIFFERENT.

A. Even if a materially different standard does apply, which we dispute (Petitioner's Brief at 26-43), then that standard has been met by Cottage Savings Association. The controlling decisions of this Court establish that

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<sup>1</sup> *Centennial Sav. Bank FSB v. United States*, 887 F.2d 595 (5th Cir. 1989), cert. granted, 59 U.S.L.W. 3243 (U.S. Oct. 1, 1990) (No. 89-1926); *First Fed. Savs. & Loan Ass'n of Temple v. United States*, 887 F.2d 593 (5th Cir. 1989), petition for cert. pending, No. 89-1927; and *San Antonio Savs. Ass'n v. Commissioner*, 887 F.2d 577 (5th Cir. 1989), petition for cert. pending, No. 89-1928.

<sup>2</sup> *Federal National Mortgage Ass'n v. Commissioner*, 896 F.2d 580 (D.C. Cir. 1990), petition for cert. pending, No. 89-1987.

whether or not exchanged assets are materially different is determined by reference to objective factors. In *United States v. Phellis*, 257 U.S. 156, 173 (1921), the Court held that shareholders realized gain when the DuPont Company reorganized from a New Jersey to a Delaware corporation, because the exchanged stock had "property rights and interests [that were] materially different."<sup>3</sup> Likewise, in *Marr v. United States*, 268 U.S. 536, 541 (1925), the Court held that, because of "differences in rights and powers" between exchanged shares, General Motors' stockholders realized gain upon the company's reincorporation in a different state. Thus, this Court has adopted a narrow and objective standard, under which realization fails to occur only if the taxpayer holds the same property rights and interests before and after the exchange.

In contrast, the Government would have the determination of whether realization occurs depend upon a subjective analysis of the parties' conduct and intent, and on an economic evaluation of the relevant marketplace. This Court, however, has never inquired into these subjective factors in resolving the issue of realization and the Government cites no cases in this regard. To the contrary, the Court's opinions establish that such factors are irrelevant. In *Phellis*, the Court concluded that the "design and purpose of the participants" were of no consequence and, further, that a comparison of the values assigned by the marketplace to the exchanged stock was a "circumstance of no particular importance." 257 U.S. at 170, 172. In *Marr*, the Court observed that in *Phellis*, *Rockefeller*, *Cullinan*, and *Marr* "the business enterprise actually conducted remained exactly the same." 268 U.S. at 540. Thus, in these cases, the parties did not intend to exchange stock that was economically different and, to the marketplace,

the stock exchanged had identical potential future performance. Yet, notwithstanding these considerations, the Court held in each of the cases that a realization event had occurred.

Application of Respondent's subjective test would result in the determination that realization did not occur in *Phellis*, *Rockefeller*, *Cullinan*, and *Marr*. Accordingly, if the Court were to adopt Respondent's test, it would have to reject both the reasoning applied and the result reached in its seminal realization cases.

B. If, as the Government suggests, the Court abandons its objective, brightline test for a subjective approach, the result would be to infuse an area of the tax law now well-settled with controversy, uncertainty and inconsistency.

Under a subjective approach, every determination of whether a realization has occurred henceforth would require a detailed inquiry into the conduct and intent of the parties, as well as a complete economic analysis of the relevant marketplace. Under such a test, factual controversies would proliferate, creating uncertainty and greatly complicating tax administration. For example, if the Court were to decide this case by applying a subjective test, its decision would not resolve the tax treatment of any other R-49 transaction. Rather, the tax treatment of each R-49 transaction would need to be determined based upon a detailed examination of the particular exchange. Indeed, under a subjective realization test, case-by-case determinations would be required not only in all other R-49 transactions, but in all varieties of exchanges and dispositions.

Adoption of a subjective realization test would also likely result in inconsistent treatment of similarly situated taxpayers. Exchange transactions that were objectively identical could be treated differently depending upon conclusions regarding the conduct and intent of the parties to the transactions. Moreover, parties to the very same transaction (including the same R-49 transaction)

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<sup>3</sup> The Court followed *Phellis* in *Rockefeller v. United States*, 257 U.S. 176 (1921), and *Cullinan v. Walker*, 262 U.S. 134 (1923), again holding that gain was realized upon exchanges of stock.

could be treated differently depending upon their individual actual or alleged intentions. That such uncertainty and inconsistency would result from so fundamental a question as the realization of gain or loss illustrates the unsuitability of the Government's subjective test.

C. In this case, objective factors demonstrate a material difference between the exchanged mortgages. The fact that the mortgages exchanged had different obligors and were secured by different underlying properties establishes as a matter of law that the mortgages were materially different. Additional inquiry into the record confirms that the exchanged mortgages had different delinquency, default and prepayment characteristics, and that they actually performed differently in these respects. See Petitioner's Brief at 7. These differences are highlighted by the fact that the exchanged mortgages varied by geographic location. Petitioner's Brief at 7. Given these and many other objective differences between the mortgages exchanged, there can be no doubt that Cottage held different property rights before and after the transaction and that the exchanges in question here are properly considered realization events.

D. As mentioned above, the Government relies heavily on subjective factors including the conduct and intent of the parties to demonstrate that the differences in the mortgage loans were not material. The Respondent's Brief at 28-32, *Centennial* (No. 89-1926), the Amicus Curiae Brief of the United States League of Savings Institutions at 17-20, *Centennial* (No. 89-1926) and the Amicus Curiae Brief of the Federal National Mortgage Association at 19-24, *Centennial* (No. 89-1926) all point out the fallacy in the Government's arguments with respect to material difference and need not be restated here.

E. Finally, the government's argument that Cottage did not realize a loss on the exchange of mortgage loans hinges on the definition of "material" in the phrase "materially different" since it is clear that Cottage exchanged completely "different" mortgage loans in the

transaction at issue. Respondent's Brief at 18, n. 15, *Centennial* (No. 89-1926). As pointed out in Respondent's Brief at 29, *Centennial* (No. 89-1926), the Government relies on dictionaries rather than the law for its definition of "material difference." The Fifth Circuit in *San Antonio, Centennial* and *First Federal of Temple* and the D.C. Circuit in *Federal National Mortgage Association* properly applied an objective test for material difference.

For the reasons set forth in this Reply Brief and in the Brief for Petitioner previously filed, the decision of the Court of Appeals for the Sixth Circuit should be reversed.

Respectfully submitted,

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